Statement

Multiple Employer Welfare Benefits for Working Americans

Submitted by:

Niche Plan Sponsors, Inc.
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Committee On Finance
US Senate

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Chairman Baucus, Ranking Member Grassley, and Members of the Committee, thank you for this opportunity to describe the benefits working Americans receive from welfare benefit trusts set up under Internal Revenue Code (IRC) Section 419A(f)(6). We urge you to take the necessary steps required to assure that these valuable benefits remain available to employees of America's small businesses.

First, an introduction: Niche Plan Sponsors, Inc. is itself a small business. We have three owners, with seven full-time employees and two part-time employees. We sponsor three 419A(f)(6) trusts, with over 452 participating employers. Our trusts provide life insurance and severance benefits to *all* of the participating employers' employees, including the owner-employees.

The Purpose of 419A(f)(6) Trusts: Provision of Welfare Benefits

The ability to participate in a multiple employer welfare benefit plan allows all employers—especially small employers—to offer a benefits package that enables them to attract and retain a quality workforce. In addition to the traditional life and health insurance type benefits, the benefits package frequently includes severance benefits. These severance benefits give employees a measure of confidence and security in making a decision to work for a small company that is more vulnerable to dissolution, acquisition, or outright failure as a result of market swings, economic downturns, under-capitalization, cash flow shortages, and other known plights of small business.

Both the amount and the timing of severance benefits are limited by law—benefits can be paid only when severance occurs unexpectedly, and they are limited in amount by a Department of Labor regulation ,that specifies that a severance benefit may not exceed twice the amount of the worker's annual compensation in the year prior to the severance event..

Welfare benefits provided pursuant to Section 419A(f)(6) are bona fide benefits to the employees whose employers adopt such plans, and are necessary to the ongoing success and prosperity of such businesses. Continuing to allow a tax incentive to provide these benefits is in the best interest of the business community, and the workers, who in most cases would not otherwise be covered by such benefits.

This truth is well illustrated by the current crisis engendered by the collapse of the Enron Corporation. Thousands of Enron rank-and-file workers did not receive their promised (but unfunded) severance benefits when they were laid off after Enron filed for bankruptcy late last year. Their claims to those severance benefits are just some of many claims among the creditors of the bankrupt Enron Corp. If these workers receive any benefits at all, it will be mere pennies on the dollar, and months, if not years, after being laid off.

Had Enron participated in a 419A(f)(6) multiple employer welfare benefit plan, monies to pay the severance benefits would have been available to those laid-off workers, because the money would have been held in an independent third-party trust, outside the reach of Enron and its creditors.

Although under current law and current business conditions, it is unlikely that a corporation as large as Enron would choose to participate in a 419A(f)(6) plan, it remains indisputable that had Enron had a 419A(f)(6) plan, Enron's workers would not have lost severance benefits at the very time they needed them most.

Even though Enron type workers might be less likely to benefit from an independently administered, funded welfare plan, workers at small companies—who are more likely to be at risk for bankruptcy during rough economic conditions—do benefit from the protections afforded by a 419A(f)(6) plan. And if the necessary modifications to IRC Section 419A(f)(6) are made, it is at least possible that larger companies would find these plans an affordable way to be sure their workers are protected should business downsizing or outright failure occur.

Currently, the welfare benefits typically provided by a multiple employer plan include death benefits and severance benefits. These are the benefits offered by Niche Marketing Inc.'s trusts. Health insurance and disability income insurance are also allowable benefits that are provided by some multiple employer welfare benefit plans. Some plans also provide long-term care and/or post-retirement medical benefits.

Most small businesses that provide welfare benefits provide them in addition to retirement plans, such as a 401(k) or a pension/profit-sharing plan. Severance benefits are not provided as an alternative to pension plans. In fact, severance benefits are forfeited to the multiple employer trust (not the remaining employees of the employer group) at the retirement of the employee.

A software company in California is a fair example of how severance benefits have provided meaningful benefits to its employees and allowed the business to recruit top-level employees in their field. Technology is a highly competitive field, with fluctuating ups and downs for smaller firms. However, the ability of these firms to recruit and retain skilled employees is crucial to the firms' success.

The California company we're describing here employed 12 people. Their adopted welfare benefit plan levels included a death benefit of ten times compensation and a severance benefit of 10% of compensation per year of service. Following a financial setback, a much larger firm purchased the business in March 1999. The successor firm did not employ the employees, except for the owner-employees. But the employees of the old, small firm received severance benefits—taxed as ordinary income—from the welfare benefit plan, giving them the financial cushion they needed while they found new employment.

If the employer had not been allowed to contribute the cost of the current liability for the stated benefits, then there would have been no money available to provide severance benefits at the time the business was sold. These workers would then have had to deplete their savings, if any, or try to live on unemployment compensation.

In other words, small businesses typically do not have the same ability to "pay as you go" as do larger firms. When properly used, these plans do not offer an unfair advantage to small business—large businesses are also eligible to participate in multiple employer welfare benefit plans. In fact, they instead help small businesses compete with bigger firms for a quality work force.

In short, participation in a 419A(f)(6) trust levels the playing field. It helps minimize a competitive advantage a bigger employer would otherwise enjoy in putting together a compensation package. It puts small employers on a more equal footing as they compete with larger, more established employers for quality workers.

Here's how it works. IRC Section 419A(f)(6) authorizes a tax deduction for contributions to welfare benefit plans within a framework of defined rules. Generally, 10 or more employers must band together to provide welfare benefits; no one participating employer can normally contribute more than 10% of the total plan contributions; there can be no experience rating by employer—i.e., all of a trust's assets at all times must be available to pay benefits to any employee of any participating employer; and there can be no retirement or other deferred compensation type benefits provided through the plan. Assets are independently trusteed and administered, and can never revert to the employer.

The rules seem clear to many 419A(f)(6) plan sponsors, administrators and participants. However, in recent years the ambiguity of the rules has resulted in some advisors recommending strategies that make aggressive use of the 419A(f)(6) rules. Many experts, both in and out of government, believe that a market has arisen for 419A(f)(6) plans that is primarily driven by a desire to shelter income from tax, rather than to provide benefits to employees. Consequently, there is concern about whether the rules need to be tightened to be sure they work as Congress intended—to provide a way to allow 10 or more employers banding together to offer real benefits to real workers.

Initial Proposal to Clarify, Tighten Falls Short

The first salvo in the debate on whether or how to clarify the rules occurred three years ago in then President Clinton's FY 2000 budget submission. That proposal would have limited the 419A(f)(6) deduction to contributions made to trusts that offered only group term life, health and disability income insurance.

This proposal is fatally flawed in that it would eliminate important welfare benefits—including severance benefits. Further, in disallowing the use of permanent life insurance in a trust, it would impose the very cash flow hardship that IRC Section 419A(f)(6) seeks to mitigate—ability to provide protection for employees. At the same time, the proposal, while making the trust benefits more expensive and less useful, would not adequately address the problems that are causing concern among policymakers. "Gaming" that could allow IRC 419A(f)(6) to be used to create a tax shelter could have continued, even had the Clinton proposal been enacted.

The proposal was defeated in a variety of contexts in 2000 and in 2001, but the underlying concerns that prompted the proposal in the first instance were not addressed. As a result, a cloud remains hovering over the 419A(f)(6) marketplace. Employers are uncertain about whether they can continue to participate in multiple employer welfare benefit trusts; and trust sponsors, administrators and participants cannot rely on the continued viability of this important employee benefits tool.

As a result, the usefulness of this tool as a way to attract and retain quality workers is being eroded. The existence of businesses like ours that focus on the operation of these multiple employer welfare benefits trusts, and that help businesses take care of their workforce independent of government sponsored programs is threatened.

Clarification Is Urgently Needed

The uncertainty surrounding the continued existence of multiple employer welfare benefit trusts makes the need for clear rules, as soon as possible, urgent. The rules must assure that these benefit plans operate as intended—that 419A(f)(6) trusts cannot be used as a way to fund deferred compensation on a tax-favorable basis, or as a way to circumvent pension contribution limitations. But clarifying rules, which need to be tight and clear, must also allow continued funding and payment of trust benefits.

Proposed Modifications

To achieve clear, appropriate rules, we respectfully offer a proposal that would eliminate the abuses that cause concern among policymakers and industry representatives alike, but at the same time allow continued availability of multiple employer welfare benefit trusts.

***Experience Rating:*** Our proposal would clearly restate the current law rule that prevents "experience rating" by employer. This means that no participating employer would realize the results of its own experience with respect to benefits, claims paid or forfeited, or segregated asset performance or variance from actuarial assumptions.

This is crucial to the appropriate use of permanent life insurance. It is important to emphasize that we believe that current law prevents use of experience rating by employer, whether overt or covert. But it is apparent that some in the marketplace do not read current law rules as restrictively as we do, and so it is appropriate to restate, with complete clarity, the rule that disallows experience rating by employer.

***Discrimination Rules:*** Our proposal also sets out rules that will assure that all of a participating employer's workers will benefit under the plan. Generally, the proposal follows the IRC Section 410 rules as to eligibility—an employer's plan must cover all workers who are at least age 21, who have one year of service, and who work at least 1,000 hours per year. Further, our proposal would require an employer to use the same formula for benefits for rank-and-file workers as is used for key workers and owners.

Thus, if the owner gets two times salary in death benefit and severance, the workers must also get two times salary in death benefit and severance.

***Deduction Limits:*** We propose limitations on both the level of benefit and on the allowable deduction for the annual funding of accrued benefits. In short, we urge Congress to enact a rule that would limit any year's deduction to the actual cost of the benefit being provided in that year.

***Effective Date:*** Finally, the proposal includes a fair effective date rule—one that gives participating employers and plans time in which to make the changes that would be required by this proposal in order to bring plans into compliance with the new, clarifying rules.

In short, our proposal suggests rules that would: 1) result in multiple employer welfare benefit plans that cover ***all*** a participating employer's workers; 2) appropriately limit the annual deduction available to help fund the benefits; and 3) assure that the plan works equally and as a whole for the benefit of all the workers of the participating employers.

We have tried to design a proposal that meets tax and social policy goals and that works for the entire, diverse Section 419A(f)(6) marketplace. Our own trusts will also need to make significant modifications to comply with these rules. It is likely that all multiple employer welfare benefit trusts currently in existence will face the same need to amend plan rules in order to comply.

We believe this proposal will eliminate the ability to make aggressive and inappropriate use of IRC Section 419A(f)(6), and will allow continued availability of this important tool for designing practical and attractive employee compensation and employment packages. However, the mind set of professionals whose purpose is to provide benefits may not parallel the mind set of people who are trying to maximize tax advantages for owner-employees. We recognize that, although we have tried to be complete and accurate, we may have missed some ways manipulation can occur. We are eager to work with the government's tax experts to be sure our proposal, which perpetuates an important tax incentive for small businesses desiring to protect their workers, achieves all appropriate rule-tightening.

<u>The Details of the Proposal</u>

Details of our proposal are embodied in currently-pending legislation, HR 2370. We remain willing and eager to work with you and your staffs to be sure HR 2370 works as intended. HR 2370 describes funding requirements, antidiscrimination rules, and appropriate limitations on the annual deduction. It delineates the types of benefits that should be available in a multiple employer welfare benefit plan. Finally and very importantly, it offers an effective date rule that protects employers—whose intention was to provide benefits to their workers, not tax shelters for owners and key workers—who have already entered into a Section 419A(f)(6) trust, but requires the trust to make the changes required to come into compliance with the new rules. Failure to make the

necessary changes will result in tax liability for those who fail to comply. A chart attached to this testimony outlines the elements of HR 2370.

Summary: Multiple Employer Welfare Benefit Trusts Allow Employer To Offer Well-Designed Employee Compensation Packages, But Current Law 419A(f)(6) Rules Require Clarification

It is important to the competitive well being of many American small businesses to assure the continued availability of the multiple employer welfare benefit trust mechanism. The benefits packages of life and health insurance, and severance benefits payable when termination is unexpected and without cause, are significant tools for small business' ability to attract and retain quality workers.

However, the rules governing 419A(f)(6) plans need clarification. The proposal we offer, which makes clear that all plan assets are available to pay benefits to all plan participants, eliminates the possibility of offering benefits on a discriminatory basis, and appropriately limits the annual deduction available for the funding of these benefits, solves the concerns of policymakers who seek to prevent misuse of IRC Section 419A(f)(6) as way to circumvent pension limits and/or provide deferred compensation, or as a tax shelter for owner-employees and/or key workers, but at the same time assures the continued viability of the 419A(f)(6) plan.

We respectfully request and encourage Congress to enact this proposal, as swiftly as possible.

Thank you. We would be happy to discuss any part of this proposal or issue in more detail. You can contact us directly at 949/655-1401, or through our Washington representative, Dani Kehoe, at 202/547-7566.

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**MULTI-BENEFIT EMPLOYER PLAN FOR TEN OR MORE EMPLOYERS**
**REFORM OF SECTION 419A(f)(6)**

**Proposal Embodied in HR 2370**

**March 2001**

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| **Funding Requirement** | At all times, all plan assets must be available as a single, undivided pool to provide benefits to the covered employees of all individual employers participating in the plan.<br><br>The definition of experience rating will apply as defined by the Tax Court in June, 1997 in *Booth v Commissioner*, 108 TC 524 (1997) |
| **Benefits available from the plan, on a nondiscriminatory basis** | Plans will be non-discriminatory:<br>(1) Participation in plan benefits will be provided to any employee meeting these standards: Age 21, 1,000 hours of service annually, one year of service.<br>(2) All benefit formulas must provide a uniform multiple of compensation to all participants<br>(3) A look-back rule would apply at employer termination from the trust, to include all former eligible employees terminated 24 months prior to employer termination from the trust. All eligible employees would be entitled to a prorata share of a plan's assets.<br>(4) Each employer plan must benefit at least one non-owner employee for each two owner-employees who benefit; trust must benefit at least three non-owner employees for every owner-employee benefited |
| **Distribution rules for benefits and plan assets** | ***In General***: No assets of the plan may revert to the employer. No assets may be loaned to an employee participant. An employer can only terminate its participation based on a bona fide business purpose.<br><br>***Forfeiture Pool:*** All assets in forfeiture pool must be used in a nondiscriminatory manner solely for the benefit of plan participants.<br><br>***For employers without severance benefits:*** An employer can only terminate its |

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| | participation if all employees of the employer receive a pro-rata share of the plan assets.<br><br>***For employers with severance benefits:*** If an employer offers severance benefits, the plan assets used to fund the severance benefits cannot be distributed for a purpose other than severance benefits, which are limited to 200% of compensation (as defined in IRC Section 401(a)(17)) and payable over not more than 24 months, as defined under DOL Regulation 2510 3-2(b), or other benefits as provided under the plan.<br><br>***For employers with post-retirement medical benefits:*** No assets used to fund post retirement medical benefits can be distributed for any reason other than post-retirement medical benefits. If a plan participant—including the owner—dies prior to using all his/her post-retirement medical benefits, the unused amounts revert to the plan (a forfeiture). Even when a participating business terminates participation in the plan due to insolvency, sale, merger-acquisition, or other Treasury-approved event, assets attributable to post-retirement medical benefits must stay in the plan until/unless they are paid in the form of medical expense reimbursement.<br><br>***Rollover:*** The trustee to trustee transfer of benefits from one multiple employer welfare benefit plan to a similar multiple employer welfare benefit plan will be permitted and not cause constructive receipt to a plan participant. |

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| **Benefit Levels** | ***Death Benefits:***<br><br>(1) The maximum benefit will be governed by the life insurance company providing the benefits and by the life insurance industry's standard financial underwriting guidelines.<br>(2) Minimum death benefit amounts will be determined either by the plan's formula for benefits or by the life insurance company's minimum issue, if greater than the plan formula.<br><br>***Severance Benefits:***<br><br>(1) The maximum severance benefit will be in accordance with Department of Labor regulation 2510 3-2(b) (not in excess of 200% of compensation), with countable compensation limited by pension law (IRC Section 401(a)(17)<br><br>***Post-Retirement Medical Benefits:***<br><br>(1) Normal retirement would be the year of eligibility for Medicare or total and permanent disability, as defined by Social Security<br>(2) Forfeiture: Assets to fund these benefits remain in the plan to pay benefits. If benefits are never collected, the result is a forfeiture of those assets to the welfare benefit trust.<br>(3) Pre-retirement death of the employee: medical reimbursement funds would be available to pay any uncovered medical expenses of the deceased employee's estate. |
| **Cost of Benefits** | Deductions would be limited to:<br><br>***Death Benefits:***<br><br>(1) If term insurance, the annual term insurance premium<br>(2) If whole life insurance, the level annual premium to normal retirement age (non-vanish) contract premium |

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| | (3) If universal life, the guideline level annual premium (IRC Section 7702). The Section 7702 guideline level annual premium is the level annual premium amount payable over a period not ending before the insured becomes age 95, computed in the same manner as the guideline single premium, except that the annual effective rate remains at 4% (IRC Section 7702(c).<br><br>***Severance Benefits:***<br><br>(1) Reasonable actuarial principles to purchase the level benefit stated in the plan document<br>(2) No prefunding in excess of the current level of liability for the stated level of benefits annually.<br><br>***Medical, health, disability benefits:***<br><br>(1) Insurance company premiums, and self-funding up to deductibles and elimination periods. But, self-funding would be subject to forfeiture at an employee's death or termination or termination of an employer from the welfare benefit trust. |
| **Application of new rules to existing plans** | These new rules would be effective as of the date of enactment, but benefits earned as of the date of enactment would be grandfathered at their existing level and previous deductions would be grandfathered at their existing level, if the plans are brought into compliance within 24 months of enactment |

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